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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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Office of the Secretary
Federal Communications Commission
Washington, D.C. 20554

Re: Docket 92-264. In the Matter of Horizontal and Vertical Ownership Limits, Cross-ownership Limitations, and Anti-trafficking Provisions.

Dear Sir or Madam,

On February 9, I filed the attached comments (not including two research studies also enclosed on February 9). It has come to my attention that these have been identified on the list of commenters to this Docket as comments by the "Annenberg School for Communication, University of Southern California."

Since my comments do not necessarily represent the views of the Annenberg School, I request that they be referred to in the future as Comments by "David Waterman."

Thank you very much.

Sincerely,



David Waterman
Adjunct Professor

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UNIVERSITY OF SOUTHERN CALIFORNIA

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February 8, 1993

Office of the Secretary
Federal Communications Commission
Washington, D.C. 20554

FEB 26 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Re: **MM Docket No. 92-264**: In the matter of Horizontal and Vertical Ownership Limits, Cross-ownership Limitations and Anti-trafficking Provisions.

Dear Commissioners,

I offer comments on one of the issues addressed in the *Notice of Proposed Rulemaking*:

MSO Subscriber Limits

My comments are based on two attached studies. The first, *MSOs and Monopony Power* (1990), was presented at the Telecommunications Policy Research Conference (TPRC) in 1990. The second, *Local Monopsony and "Free Riders" in Information Industries* (1992), is a more technical elaboration of the basic model in the TPRC paper.

I emphasize that neither these comments, nor any of the research on which they are based, has been supported by any party having a vested interest in the outcome of these proceedings. These comments are offered on my own volition in the public interest.

A number of commenters in previous FCC proceedings have appealed to the benchmark standards in the U.S. Justice Department's *Merger Guidelines* (1992) as a relevant standard for evaluating concentration of ownership by Multiple Cable System Operators (MSOs). These commenters point out that the Herfindahl Index (HHI) for MSOs (as measured by national shares of basic subscribers) falls below the 1000 benchmark which the Justice Department has determined to be the minimum level ordinarily warranting further investigation. They have thus concluded, as did the Commission in its 1990 *Report* on Docket 89-600, that current levels of MSO national concentration do not warrant legal constraint.

I respectfully argue here that the Justice Department standards are inapplicable to the MSO case, due to peculiarities of the cable industry and its products. Although further empirical data are still needed, it is reasonable to believe that levels well below the Justice Department's "1000" standard could result in anticompetitive behavior by MSOs.

As the *Merger Guidelines* make clear, the HHI standards are concerned with the accretion of market power through unilateral or coordinated behavior that would result from a merger within a particular market in which other firms compete for the *same* customers (or inputs). The associated behavioral standard is the resulting ability of the newly merged firm to raise its final prices (or comparably, to lower its input prices) within that particular market. The basis of the HHI benchmark standards is that if horizontal concentration is low, such a price change is unlikely to be profitable since business will rapidly flow to other firms too numerous to coordinate a similar price change. If concentration is high, however, price coordination among other firms, and thus higher profits for all, is more likely to result.

The MSO case differs from this typical scenario in two fundamental ways:

(1) The MSO-network bargaining process involves geographically separated firms.

MSOs negotiate with cable networks for the rights to exhibit programs within local market areas in which the MSO's cable systems are often the only viable means for that network's programming to reach consumers. In the attached papers, I argue that an MSO can increase its bargaining power under these circumstances by increasing its national market share of cable subscribers. In brief summary, the reason for this increase in the MSO's bargaining power follows from a basic principle of bilateral bargaining. As the MSO accumulates national market share, it comes to control a greater share of the potential revenues which a cable network *stands to lose* if the MSO does not grant it access. The share of its potential revenues that the MSO stands to lose if no deal is struck, however, remains independent of its national market share. As a result, bargaining power, and thus the negotiated division of revenues, shifts in the MSO's favor as its national share of subscribers increases.

The rate at which an MSO can accumulate bargaining power (ie, monopsony power) in this way is an empirical question. It is clear, however, that this rate has nothing to do with the standard interpretation of the Herfindahl Index, because virtually none of the cable system buyers are competing with each other for programs. Indeed, the *Merger Guidelines* make the inapplicability of the HHI standard explicit in their discussion of Geographic Market Definition. The *Guidelines* note that if geographic price discrimination is possible, then it is appropriate to consider those different geographic areas as separate markets. Obviously, cable television networks have the power to price discriminate in different geographic markets. There is, that is, no national market for cable television subscriptions.

The second factor making the MSO case different from the ordinary is a major determinant of the rate at which MSOs can accumulate monopsony power.

(2) The presence of economies of scale in cable networking

Cable television networks have inherent economies of scale in distribution because of the "public good" nature of their programming. In many cases, program distribution rights are granted to the network for a relatively constant "per subscriber" rate, which may be fairly insensitive to the number of subscribers reached. Most networks, however, offer substantial original or other exclusive programming, for which the incremental cost of carriage by additional cable systems is essentially zero. The network's average costs per subscriber thus decline rapidly as its potential market expands.

It follows that the greater are economies of scale in cable networking, the greater the importance that a network reach its maximum potential audience, and thus the greater the network's vulnerability to MSO monopsony power (ie, power to exclude the network from the local markets it controls). This would not be a serious problem except that there are often few opportunities for a cable network's programming to be exhibited on other media in those markets. Program distributors are especially handicapped by the odd geographic patterns of cable franchise areas. If one or a few of the 20 or 30 cable systems often contained in a local TV market do not carry a program, for example, its distributor's alternatives for broadcast exhibition in that franchise area remain very limited.

Of course, there are many examples of cable networks which are profitable with well below full access to cable subscribers. But even a cursory investigation will reveal that such networks tend to spend substantially less on programming, and tend to have relatively small audiences. Indeed, the economic incentive of a network to invest in programming is proportional to the total size of its potential market.

Consider an analogy in television broadcasting. From its founding in the late 1940's until the mid-1970's, ABC was the "junior" network, spending substantially less on programming, and attracting consistently smaller audiences, than either CBS or NBC. Most analysts at the time attributed ABC's status to a handicap in national audience reach that was relatively small. In 1974, for example, ABC had 181 affiliates, vs. 212 for CBS and 218 for NBC. Although a higher proportion of ABC affiliates were weaker UHF stations, these affiliate counts very likely overstate the imbalance since ABC's affiliates permitted that network to reach over 90% of U.S. TV households, compared to somewhat under 100% for CBS and NBC. It was not until a remarkable string of innovative programming decisions from 1975 to 1979 that ABC managed to equalize the audience

reach balance by inducing a number of stations to switch to ABC affiliation. Comparably, many analysts emphasize the importance of the Fox Network's longer term competitive disadvantage to the three full-time networks because Fox reaches only about 91% of U.S. TV households.

In conclusion, I emphasize that the extent of the competitive advantage of audience reach in cable television--and thus the significance of MSO monopsony power in the cable industry--is an empirical issue for which relevant data are very incomplete. Such power is likely to vary as well, depending on alternative distribution routes which the particular programming in question has. Moreover, some networks are likely to have "countervailing" market power with cable operators. Hopefully, more relevant data on this question will emerge from these proceedings. I also note that I have not considered here other important aspects of the question, such as whether antitrust enforcement or FCC limits would be a more appropriate mechanism.

My economic analysis of the cable market and the broadcasting analogy, however, strongly suggest that an MSO having less than the Commission's suggested 25%-35% national share limit may exert excessive market power over networks--particularly new entrants--in the current market environment. If so, such an MSO could force per-subscriber wholesale rates paid to networks to artificially low levels, consequently reducing program diversity. At the very least, I hope the Commission is persuaded that it should not rely on the inapplicable standard interpretation of the Herfindahl index in establishing any subscribership limits.

Sincerely,

A handwritten signature in black ink, appearing to read 'David Waterman', with a stylized, cursive script.

David Waterman
Adjunct Professor